No. 7900.

In the United States Circuit Court of Appeals

For the Ninth Circuit.

Commissioner of Internal Revenue,
Petitioner,

vs.

Carson Estate Company,
Respondent.

ON PETITION FOR REVIEW OF DECISION OF THE UNITED STATES BOARD OF TAX APPEALS.

BRIEF FOR RESPONDENT.

JOSEPH D. BRADY,
458 South Spring Street, Los Angeles, California.
Counsel for Respondent.

Parker, Stone & Baird Co., Law Printers, Los Angeles.

TOPICAL INDEX.

TABLE OF AUTHORITIES CITED.

Cases.

Statutes.

Text Books and Encyclopedias.

No. 7900.

In the United States Circuit Court of Appeals

For the Ninth Circuit.

Commissioner of Internal Revenue,
Petitioner,

vs.

Carson Estate Company,
Respondent.

ON PETITION FOR REVIEW OF DECISION OF THE UNITED STATES BOARD OF TAX APPEALS.

BRIEF FOR RESPONDENT.

Opinion Below.

The only previous opinion in this case is that of the Board of Tax Appeals [R. 23-35], which is reported in 31 B. T. A. 607.

Jurisdiction.

This appeal involves income taxes for the years 1926, 1927 and 1928 in the amounts of $1,299.24, $1,394.21 and $1,815.31, respectively, and is taken from a decision of the Board of Tax Appeals entered January 9, 1935. [R. 36.] This case is brought to this court by petition for review filed March 25, 1935 [R. 5], pursuant to the pro-

visions of sections 1001-1003 of the Revenue Act of 1926, c. 27, 44 Stat. 9, as amended by section 1101 of the Revenue Act of 1932, c. 209, 47 Stat. 169.

Question Presented.

Was the Board correct in holding that the interest income here involved flowed to respondent by reason of its beneficial ownership of an undivided interest in tax-exempt municipal improvements bonds deposited in trust?

Stated otherwise, did the Board err in rejecting the Commissioner's contention that the interest in question was interest on indebtedness of Municipal Bond Company, a private corporation?

Statutes and Regulations Involved.

The Revenue Act of 1926, c. 27, 44 Stat. 9, provides in part as follows:

> SEC. 213 (b) The term "gross income" does not include the following items, which shall be exempt from taxation under this title:
>
> * * * * * * * *
>
> (4) Interest upon (A) the obligations of a State, Territory, or any political subdivision thereof, or the District of Columbia; * * *
>
> SEC. 234 (a) In computing the net income of a corporation * * * there shall be allowed as deductions:
>
> * * * * * * * *
>
> (2) All interest paid or accrued within the taxable year on its indebtedness, except on indebtedness incurred or continued to purchase or carry obligations or securities * * * the interest upon which is wholly exempt from taxation under this title;

Section 22(b)(4) of the Revenue Act of 1928, c. 852, 45 Stat. 751, reads the same as section 213(b)(4) of the Revenue Act of 1926, and section 23(b) of the 1928 Act is substantially identical with section 234(a)(2) of the 1926 Act.

Treasury Regulations 69, promulgated under the Revenue Act of 1926, provide in part as follows:

> ART. 74. *Interest Upon State Obligations.*—Interest upon the obligations of a State, Territory, or any political subdivision thereof, or the District of Columbia is exempt from the income tax. Obligations issued by or on behalf of the State or Territory or a duly organized political subdivision acting by constituted authorities empowered to issue such obligations, are the obligations of a State or Territory or a political subdivision thereof. The term "political subdivision" denotes any division of the State or Territory made by the proper authorities thereof acting within their constitutional powers. Political subdivisions of a State or Territory within the meaning of the exemption, include special assessment districts so created, such as road, water, sewer, gas, light, reclamation, drainage, irrigation, levee, school, harbor, port improvement, and similar districts and divisions of a State or Territory. The purchase by a State of property subject to a mortgage executed to secure an issue of bonds does not render the bonds obligations of the State, and the interest upon them does not become exempt from taxation whether or not the State assumes the payment of the bonds.

Petitioner also quotes (p. 3) from Article 1541 of Regulations 69. This article, relating to dividends to stockholders of a corporation, has no proper application here—the petition for review does not contend that respondent is a *stockholder* in a corporation.

Statement.

The summary of facts contained in petitioner's brief (pp. 4-6) is, in the circumstances, sufficiently accurate and comprehensive so as to render it unnecessary for respondent to make an independent statement. Respondent should not, however, be regarded as conceding the correctness of certain of petitioner's conclusions which are reflected in his statement.

Summary of Argument.

The Board's conclusion, that respondent was the beneficial owner of an undivided interest in tax-exempt bonds, was a finding of fact, for which there was ample support in the evidence. It is, therefore, conclusive on appeal, for it cannot be fairly said that the evidentiary facts compel a finding opposed to that made by the Board.

The fallacy of the petitioner's contention is exposed when the validity of the corollary thereof is considered. The Municipal Bond Company was not indebted to respondent, and the interest received by respondent clearly was not interest on indebtedness of that company.

As shown by the stipulation of facts [R. 39], none of the interest income here involved flowed to respondent by reason of the warranties or covenants of Municipal Bond Company. The only other possible source was the tax-exempt bonds themselves, and the Board properly concluded that such interest was not taxable.

ARGUMENT.

I.

The Ultimate Question Is One of Fact and There Being Substantial Evidence to Support the Finding of the Board, Such Finding Is Conclusive on Appeal.

The judgment in the instant case can be, and, it is respectfully submitted, should be, affirmed on the authority of the decision of this court, December 5, 1935, in *Commissioner v. The Bank of California, National Association,* ..... F. (2d) ....., affirming a decision of the Board of Tax Appeals, 30 B. T. A. 556. Both the *Bank of California* case and the instant case were reviewed by the entire Board. One member of the Board dissented in that case; none dissented here. [R. 35.]

In the case cited, the Bank of California claimed to be the *owner* of certain tax-exempt bonds acquired from R. H. Moulton & Co., an investment banking firm, by bills of sale, absolute on their face. Simultaneously with the execution of the bill of sale the parties entered into a repurchase agreement.

The Commissioner asserted that although in form the transactions were purchases and sales of bonds, they were *intended* to be and were, in fact, loans of money by the Bank to Moulton & Co., secured by pledge of the bonds in question, and the bonds never were, in fact, the property of the Bank.

The Board, after reviewing the evidence said (30 B. T. A. 552, 561-2):

> "In view of the facts in the case before us, we are of the opinion that the tax-free securities belonged to petitioner and that the interest received by and ac-

> crued to the petitioner from such securities as were covered by the repurchase agreements as above set forth is exempt from taxation under the provisions of section 22(b)(4) of the Revenue Act of 1928."

Upon the Commissioner's petition to review, this court said:

> "*The issue thus presented is one of fact,* which the Board of Tax Appeals has decided in favor of respondent. The Board found that the transactions referred to were actual purchases, not loans of money secured by pledge, and that the bonds belonged to and were the property of respondent. *This finding is supported by substantial evidence and is, therefore, conclusive.*" (Citing cases.) (Italics supplied.)

In the instant case, the Municipal Bond Company was in the business of acquiring and selling municipal improvement bonds, issued under special assessment laws of the State of California. Said bonds were rarely in denominations of an even sum such as $100, $500 or $1000. Instead of selling to a purchaser certain specific bonds, Municipal Bond Company was desirous of *selling* "an interest in such bonds," such as $100, $500 or $1000, and reinvesting for such purchaser the principal of such bonds, or annual installments thereof, as and when the same matured and was paid, in other like bonds, to the end that the purchaser might have his money invested in such bonds for a definite period of time, such as five years or ten years. [R. 40-41.]

In order to accomplish this purpose, Municipal Bond Company executed a trust instrument and deposited with the trustee the tax-exempt municipal improvement bonds. [R. 40-59.] It then proceeded to "sell and transfer" to

purchasers (of whom respondent was one) "all of its rights, title and interest in" the tax-exempt bonds of a certain unpaid face value. This sale was evidenced by a certificate—termed Municipal Bond Company Convertible Certificate of Ownership in Municipal Improvement bonds—executed by the Municipal Bond Company and bearing the certification of the trustee. A typical form of the ownership certificate is printed in the record. [R. 60-63.]

The Commissioner, on the theory that the transaction between Municipal Bond Company and the respondent was not what it professed to be, namely, a *sale* to respondent of an undivided interest in tax-exempt bonds deposited in trust, but was, rather, a loan by respondent to Municipal Bond Company, held that the interest income received by respondent was not received by reason of beneficial ownership in tax-exempt bonds but flowed from an obligation of the Municipal Bond Company. Accordingly, the Commissioner held that the interest was not tax-exempt to respondent.*

The Board, from the evidence before it, found that the professed background and purpose of the transaction (to *sell* an interest in tax-exempt bonds) stood uncontradicted; that there was no history or suggestion branding the Municipal Bond Company as at any time a borrower or the respondent as a lender; that the record indicated only that said parties were seller and purchaser, respectively; and that respondent was a beneficial *owner* of tax-exempt

---

*Since someone *owns* the tax-exempt bonds, the necessary corollary of the Commissioner's theory is that the interest is tax-exempt to Municipal Bond Company. The unsoundness of this corollary will be demonstrated under Point II, *infra*, p. 11.

bonds, and received the controverted "interest income" as such, thereon, free from income tax. [R. 35.]

If the Commissioner wished to support his utterly strained interpretation and construction of the transaction; if he desired to have the Board *find* that the Municipal Bond Company's business was really not that of buying and selling tax-exempt bonds or interests therein, but was really that of a borrower of money for the purpose of itself making relatively long-term investments in such bonds,—he should have introduced evidence tending to prove such fact. Compare, for example, the evidence introduced by the taxpayer in *United National Corporation v. Commissioner,* 33 B. T. A. No. 119 (promulgated December 27, 1935).* Evidence of such character would have been a showing (if such proof was in fact available) that on its books of account Municipal Bond Company carried a liability for the amounts paid to it by the holders of its convertible certificates of ownership and an asset representing the tax-exempt bonds.

The Commissioner, having failed to adduce any evidence of this character, can not now be heard to complain because the Board has unanimously found that the recitals of the Municipal Bond Company were in accordance with, and not contrary to, the real transaction between it and the respondent.

The opinion of the Board adequately answers the points which respondent made based upon the language of the trust instrument, and there is, therefore, no occasion unduly to extend this brief by repeating the discussion here-

---

*See, also, a recent decision of the Fourth Circuit—*Commissioner of Internal Revenue v. The H. F. Neighbors Realty Co.*—(January 14, 1936) reported C. C. H. 1936 Tax Service, Vol. 3, paragraph 9071.

in. But the attention of the court is respectfully directed to the stipulation that none of the interest income here involved flowed to respondent by reason of any of the warranties or covenants of Municipal Bond Company [R. 39].

Furthermore, even if the ultimate fact as found by the Board were without substantial support in the evidence, this would still not avail the Commissioner in this case for the reason that his petition for review contains no assignment of error to that effect [R. 67-68]. Cf. *General Utilities and Operating Co v. Helvering,* 80 Law Ed. 174.

II.

The Corollary of the Commissioner's Theory—That the Interest Received by Respondent Was Interest on Indebtedness of Municipal Bond Company—Is Demonstrably Unsound.

The Commissioner says in effect that the interest received by respondent was paid by Municipal Bond Company as interest on *its* indebtedness.

Was Municipal Bond Company indebted to respondent by virtue of the issuance of its convertible certificate of ownership? First, let us make certain as to the meaning of "indebtedness"as used in said section 234 (a) (2). "The legislature must be presumed to use words in their known and ordinary signification." *Levy's Lessee v. M'Cartee,* 6 Pet. 102, 8 L. Ed. 334, cited in *Old Colony Railroad Co. v. Commissioner,* 52 S. Ct. 211, 213.

Are the Ownership Certificates evidences of *indebtedness* of Municipal Bond Company? Is the interest received by the certificate holder "interest paid * * * within the taxable year on * * * indebtedness" of the Munic-

ipal Bond Company within the meaning of Section 234 (a) (2) of the Revenue Act of 1926 and the comparable provision of the 1928 Act—Section 23 (b)?

The term "indebtedness" is defined, in Rawle's Third Revision of Bouvier's Law Dictionary, page 1531, in the following language:

> "INDEBTEDNESS. The state of being in debt, without regard to the ability or inability of the party to pay the same. See 1 Story, Eq. Jur. 343; 2 Hill, Abr. 421.
>
> But in order to create an indebtedness there must be an actual liability at the time, either to pay then or at a future time. If, for example, a person were to enter and become surety for another, who enters into a rule of reference, he does not thereby become a debtor to the opposite party until the rendition of the judgment on award; Fales v. Thompson, 1 Mass. 134. As to indebtedness of a municipality, see MUNICIPAL CORPORATION."

Black's Law Dictionary, published by West Publishing Company, defines the term "indebtedness" in identically the same manner as the first paragraph quoted above from Bouvier's, and then adds the following paragraph:

> "The word implies an absolute or complete liability. A contingent liability, such as that of a surety before the principal has made default, does not constitute indebtedness. On the other hand, the money need not be immediately payable. Obligations yet to become due constitute indebtedness as well as those already due. 9 Mo. 149."

In *People v. Arguello,* 37 Cal. 524, the Supreme Court of California said:

> "A sum of money which is certainly and at all events payable is a debt, without regard to the fact whether it be payable now or at a future time. A sum payable upon a contingency, however, is not a debt, nor does it become a debt until the contingency has happened."

See, also, *In re City of San Francisco,* 191 Cal. 172 at 183.

The language of the Ownership Certificate [R. 60-63] will be scrutinized in vain for any definite and absolute promise of Municipal Bond Company to pay a sum of money, with interest thereon. The certificate provides that the holder thereof—

> "is entitled to participate *in* the proceeds and avails *of* such bonds, so deposited, to the extent of the principal sum of ..... Dollars, payable *from* such proceeds and avails on the ..... day of ...., 19...., with interest on said sum from the date hereof," etc. [R. 60.] (Italics supplied.)

The interest coupon [R. 63] provides that the Bearer "is entitled to receive ..... Dollars *from the avails* of Bonds on deposit with said Bank in Trust No. ....., according to the terms of such Trust, and the Undersigned covenants that the avails *from such bonds* will be paid." [R. 63.] (Italics supplied.)

The Municipal Bond Company covenants [R. ....] "that the principal and interest to become due *upon said bonds,*

when and as the same matures, will be paid." [R. 62.] (Italics supplied.)

These covenants obviously and clearly relate to the payment of the principal and interest of the *deposited* tax-exempt bonds. They are in the nature of a contingent guaranty and clearly do not represent a primary obligation. Until there is a default in the payment of the principal or interest by the obligors of the deposited bonds, there is no "indebtedness" of Municipal Bond Company, and, therefore, there can be no "interest" on any "obligations" of that company. The stipulation of facts affirmatively recites that during the taxable years in question none of the interest income in controversy in this case flowed to respondent by reason of any of the warranties or covenants of Municipal Bond Company [R. 39]. There was only one other source of such interest income and that was the primary source of the tax-exempt bonds themselves. Such interest was received by respondent because respondent, at the time it acquired the Ownership Certificates from Municipal Bond Company, purchased an undivided beneficial interest in the tax-exempt bonds. As the Board found [R. 34], the release and waiver of the interest in excess of 6% [R. 61] is a provision that is completely consistent with the vesting of such beneficial ownership in respondent—if Municipal Bond Company continued to be the owner of the tax-exempt bonds, there would have been no occasion for such release and waiver.

III.

Petitioner's Authorities Distinguished.

Petitioner contends (Br. p. 12) that a case quite similar to the instant one is *First National Bank in Wichita v. Commissioner,* 57 F. (2d) 7 (C. C. A. 10th).

The cases are similar only in the sense that they involved a similar question of ultimate *fact.* The evidentiary facts are utterly different. The Board of Tax Appeals was clearly right in its finding of ultimate fact, as the Circuit Court of Appeals for the 10th Circuit held in affirming the Board. In its opinion [57 F. (2d) 7] the Appellate Court said:

> "So, the issue is one of fact."

Examination of the opinion of the Board, particularly at page 749 of 19 B. T. A. 744, will show that the Board reached its conclusion in the *Wichita* case based upon oral testimony as to the *motives* of the parties, that is, First National Bank and Brown-Crummer Co. Except for such oral evidence it is clear that the taxpayer's contention would have been sustained, for the Board said:

> "We think there could be no question as to the soundness of the petitioner's contention had it taken title to these securities subject to no conditions other than is evidenced by the repurchase agreements; however, other established facts show that other considerations formed the motives of the parties to the transactions."

The instant case was submitted to the Board on a written stipulation of "agreed facts without other testi-

mony by either party." [R. 38.] This court will not attempt to weigh the evidence—the petition for review will be denied if there is any substantial evidence to support the finding of the Board. Even if the petition for review were adequate, which is not the case, this court would not reverse the Board's finding of the ultimate fact unless, as is not the case here, the "evidentiary facts"—

> "compel an opposite conclusion as a matter of law."
>
> (*Tricou v. Helvering,* 68 F. (2) 280.)

That the Board had in mind, in reaching its conclusion herein, its own decision in the case of *First National Bank in Wichita,* is shown by the citation thereof [R. 31].

To be sure, in weighing the evidence, the Board was required, under *Heryford v. Davis,* 102 U. S. 235, cited by petitioner, p. 9, to read the ownership certificates and the trust instrument together, and reach its own conclusion without regard to "the name by which the transaction may be labelled by the parties." The record shows, however, that the Board did this very thing, and *Heryford v. Davis, supra,* is cited in the Board's opinion [R. 31]. But doubtless the Board also had in mind another equally salutary rule, namely, that—

> "it is not lightly to be assumed that parties have given an erroneous name to their transactions."

(*Kentucky River Coal Corp.,* 3 B. T. A. 644; *Angelus Bldg. & Investment Co.,* 20 B. T. A. 667 at 677, affirmed by this court, *Angelus Bldg. & Investment Co. v. Commissioner,* 57 F. (2d) 133.) And see, also, *Henrietta Mills, Inc. v. Commissioner,* 52 F. (2d) 931, 934, where the Circuit Court of Appeals, 4th Circuit, citing numerous

decisions of the highest court, said that courts will not disregard the plain language of a contract or interpolate something not contained in it.

The remaining authorities cited by the Commissioner are not pertinent to any issue presented by the petition for review and, therefore, require no further comment here.

Conclusion.

It is clear that the Board's finding is one of fact and that it is amply supported by the evidence. The judgment should, therefore, be affirmed.

Respectfully submitted,

JOSEPH D. BRADY,
458 South Spring Street, Los Angeles, California.
Counsel for Respondent.